Nos. 760 and 781

In the Supreme Court of the United States

October Term, 1967

Commissioner of Internal Revenue, petitioner
v.
Irving Gordon and Margaret Gordon

Oscar E. Baan and Evelyn K. Baan, petitioners
v.
Commissioner of Internal Revenue

ON WRITS OF CERTIORARI TO THE UNITED STATES COURTS OF APPEALS FOR THE SECOND AND NINTH CIRCUITS

BRIEF FOR THE COMMISSIONER

ERWIN N. GRISWOLD,
Solicitor General,
MITCHELL ROGOVIN,
Assistant Attorney General,
HARRIS WEINSTEIN,
Assistant to the Solicitor General,
GILBERT E. ANDREWS,
MARTIN T. GOLDBLUM,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statute involved	2
Statement	2
Summary of argument	11
Argument:	
Introduction	15
I. Pacific did not distribute "solely stock or securities" of Northwest	23
II. Pacific did not "distribute to a shareholder with respect to its stock" the Northwest stock	29
A. The Internal Revenue Code consistently uses the phrase "distribute with respect to stock" to refer only to distributions to shareholders without consideration	29
B. Viewing the $16 cash consideration as a contribution to the capital of Pacific would be inconsistent with commonly accepted ideas of what constitutes a sale and its tax consequences	31
C. The requirement of consideration is inconsistent with the statutory provision that the distribution be to the parent's shareholders	34
D. The requirement of consideration is inconsistent with congressional intention that a tax-free spin-off result in a genuine contraction of the original corporate enterprise	35
III. Two separate distributions, of 57 and 43 percent of the stock made over a period of 21 months do not satisfy the requirement of Section 355(a)(1)(D) that the parent distribute at least 80 percent of the voting stock of the subsidiary	40

Argument—Continued

IV. Shareholders who sold and did not exercise the rights Pacific distributed thereby realized ordinary and not capital income ---------- Page 46

Conclusion ---------- 51

Appendix ---------- 53

CITATIONS

Cases:

Braunstein v. *Commissioner*, 374 U.S. 65 ---------- 39

Burnet v. *Sanford & Brooks Co.*, 282 U.S. 359 ---------- 42

Choate v. *Commissioner*, 129 F. 2d 684 ---------- 26, 46, 51

Commissioner v. *Brown*, 380 U.S. 563 ---------- 34

Commissioner v. *LoBue*, 351 U.S. 243 ---------- 12, 27

Commissioner v. *Wilson*, 353 F. 2d 184 ---------- 17

Crane v. *Commissioner*, 331 U.S. 1 ---------- 19, 31, 40

Eisner v. *Macomber*, 252 U.S. 189 ---------- 25, 28

Gibson v. *Commissioner*, 133 F. 2d 308 ---------- 37, 46, 51

Gregory v. *Helvering*, 293 U.S. 465 ---------- 17, 20, 21, 22

Hanover Bank v. *Commissioner*, 369 U.S. 672 ---------- 39

Helvering v. *Southwest Consolidated Corp.*, 315 U.S. 194 ---------- 11, 23, 26

Malat v. *Riddell*, 383 U.S. 569 ---------- 45

Palmer v. *Commissioner*, 302 U.S. 63 ---------- 12, 26, 27, 46, 47

Parshelsky's Estate v. *Commissioner*, 303 F. 2d 14 ---------- 17

Statutes:

Internal Revenue Code of 1939:

Sec. 112 (26 U.S.C. 1952 ed., Sec. 112) ---------- 18, 24

Sec. 373 (26 U.S.C. 1952 ed., Sec. 373) ---------- 24

Internal Revenue Code of 1954:

Sec. 118 (26 U.S.C. Sec. 118) ---------- 33

Sec. 172 (26 U.S.C. 172) ---------- 42

Sec. 301 (26 U.S.C. Sec. 301) ---------- 30, 47, 48

Sec. 305 (26 U.S.C. Sec. 305) ---------- 25, 28, 30, 47

Sec. 307 (26 U.S.C. Sec. 307) ---------- 30, 50

Sec. 311 (26 U.S.C. Sec. 311) ---------- 25, 30, 31

Sec. 312 (26 U.S.C. Sec. 312) ---------- 30

Sec. 316 (26 U.S.C. 316) ---------- 48

Sec. 317 (26 U.S.C. Sec. 317) ---------- 25, 28, 48

Sec. 331 (26 U.S.C. Sec. 331) ---------- 36

Sec. 346 (26 U.S.C. Sec. 346) ---------- 36

Statutes—Continued
Internal Revenue Code of 1954—Continued Page
Sec. 355 (26 U.S.C. Sec. 355) 2, 10, 11, 12, 13, 14, 15, 16, 18, 19, 21, 23, 29, 34, 35, 36, 37, 39, 40, 41, 42, 43, 44, 45, 46, 50, 53.
Sec. 358 (26 U.S.C. 358) 34
Sec. 368 (26 U.S.C 368) 16
Sec. 381 (26 U.S.C. 381) 42
Sec. 382 (26 U.S.C. 382) 42
Sec. 1001 (26 U.S.C. Sec. 1001) 31
Sec. 1002 (26 U.S.C. Sec. 1002) 31
Sec. 1012 (26 U.S.C. 1012) 34
Sec. 1081 (26 U.S.C. Sec. 1081) 24
Sec. 1082 (26 U.S.C. 1082) 24
Sec. 1083 (26 U.S.C. Sec. 1083) 24
Sec. 1301 (26 U.S.C. 1301) 42
Sec. 1302 (26 U.S.C. 1302) 42
Sec. 1303 (26 U.S.C. 1303) 42
Sec. 1311 (26 U.S.C. 1311) 42
Sec. 2055 (26 U.S.C. 2055) 42
Sec. 6214 (26 U.S.C. 6214) 10
Revenue Act of 1924, c. 234, 43 Stat. 253, 256–257, Sec. 203(c) 17
Revenue Act of 1934, c. 277, 48 Stat. 680 17
Miscellaneous:
Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, (2d ed.) 19, 43
Carlson, *Taxation of "Taxable" Stock Rights: The Strange Persistence of Palmer* v. *Commissioner*, 23 Tax L. Rev. 129 29, 49
H. Rep. No. 2543, 83d Cong., 2d Sess 37
Rev. Rul. 67–299, 1967–37 Int. Rev. Bull. 8 37
S. Rep. No. 1567, 75th Cong., 3d Sess 24
S. Rep. No. 781, 82d Cong., 1st Sess 17, 18
S. Rep. No. 1622, 83d Cong., 2d Sess 19, 36
Surrey & Warren, *Federal Income Taxation* (1960) 43
Treasury Regulations on Income Tax (1954 Code):
Sec. 1.118–1 (26 C.F.R., Sec. 1.118–1) 34
Sec. 1.263(a)–2(f) (26 C.F.R., Sec. 1.263(a)–2(f)) 34
Sec. 1.301–1(j) (26 C.F.R., Sec. 1.301(j)) 37
Sec. 1.346–1(a) (26 C.F.R., Sec. 1.346–1(a)) 36
Whiteside, *Income Tax Consequences of Distributions of Stock Rights to Shareholders*, 66 Yale L.J. 1016 29

In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 760

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

IRVING GORDON AND MARGARET GORDON

No. 781

OSCAR E. BAAN AND EVELYN K. BAAN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES COURTS OF APPEALS FOR THE SECOND AND NINTH CIRCUITS

BRIEF FOR THE COMMISSIONER

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 227–271) are reported at 45 T.C. 71. The opinion of the Second Circuit in No. 760 (R. 275–305) is reported at 382 F. 2d 499, and that of the Ninth Circuit in No. 781 (R. 308–333) at 382 F. 2d 485.

JURISDICTION

In No. 760, the judgment of the court of appeals was entered on July 26, 1967 (R. 9, 306–307), and

the petition for a writ of certiorari was filed on October 23, 1967. In No. 781, the judgment of the court of appeals was entered on July 7, 1967, rehearing was denied on August 15, 1967 (R. 10, 334), and the petition for a writ of certiorari was filed on November 2, 1967. Both petitions were granted on January 15, 1968. (R. 335–336.) The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether a corporation's distribution to its shareholders of transferable rights to purchase at a price substantially less than fair-market value 57 percent of the stock of a wholly-owned subsidiary, where rights to purchase the remaining 43 percent were distributed twenty-one months later, qualifies for the nonrecognition of gain treatment that Section 355 of the Internal Revenue Code of 1954 allows certain distributions to shareholders of stock of a controlled subsidiary.

2. Whether the amount realized by a shareholder of the parent corporation upon the sale of such rights is ordinary dividend income or capital gain.

STATUTE INVOLVED

Section 355 of the Internal Revenue Code of 1954 appears in the Appendix, *infra*, pp. 53–56.

STATEMENT

American Telephone & Telegraph Company ("A.T. & T.") conducts its local communications business through a number of subsidiaries. In 1960, there were 20 such companies, which operated in every state except Hawaii and Alaska. (R. 230–231.)

Pacific Telephone & Telegraph Company ("Pacific") is one of A.T. & T.'s operating subsidiaries. Since 1907, A.T. & T. has owned more than 80 percent of the voting stock of Pacific. (R. 230.) Throughout 1961, it owned about 90 percent of Pacific's common stock. It also held approximately 78 percent of the preferred stock, which carried seven votes for each share. In the aggregate, A.T. & T. had 89.62 percent of the voting power. Some 38,000 persons owned the minority interests. (R. 233.) Since 1954, Pacific's federal income tax liability has been included as that of an affiliated subsidiary corporation in a consolidated tax return filed by A.T. & T. on behalf of itself and its subsidiaries (R. 233–234).

Through 1960 Pacific provided communications services in California, Oregon, Washington and Idaho, and served parts of Nevada through a wholly-owned subsidiary (R. 229, 230). In the dozen or so years following World War II, Pacific's business had increased more than five-fold, so that it became A.T. & T.'s largest subsidiary (R. 234–235). Some time in 1958 its management decided to investigate the possibilities of dividing the company into two or three separate corporations (R. 235). In addition to securing a more efficient management through decentralization (R. 236–237), Pacific had several distinct objectives and conditions that it wished to satisfy through such a division: to assure that A.T. & T. would, from the beginning, have a majority of the voting stock of the new entity (R. 90–91, 125, 164, 209–210, 281); to generate through the transaction enough cash to liquidate a substantial portion of Pacific's accumulated in-

debtedness to A.T. & T.; and to provide funds to cover Pacific's capital needs (R. 90–91, 103–104, 108–109, 191–192, 215, 226). Pacific, however, did not want to "have excess cash left over which would have to be invested temporarily at a low return". (R. 91), and wanted to minimize the tax consequences of the transaction to itself (R. 220–222). It also was interested in making the transaction attractive to Pacific's minority shareholders (R. 202, 249–251).

The ultimate result was a plan to separate the businesses Pacific conducted in Oregon, Washington, and Idaho from its operations in California and Nevada (R. 237–238). A new corporation, Pacific Northwest Bell Telephone Company ("Northwest") was formed. It issued 10,000 shares of its stock to Pacific for which it was paid $110,000 (R. 241). Pacific then transferred its assets and liabilities in those three states to Northwest in exchange for 30,450,000 shares of Northwest's common stock and a $200,000,000 demand note (R. 90–93, 242–243).

Because of Pacific's need to raise cash, and possible difficulties under state law, Pacific's management decided not to distribute the Northwest stock without payment by Pacific's shareholders (R. 239–240). Instead, Pacific decided that as soon as possible after it received the Northwest stock, Pacific would offer to sell approximately 56 percent of that stock to the holders of Pacific's common and the minority holders of Pacific's preferred. The sale of that amount would enable A.T. & T. to secure "more than 50% control" of Northwest, and yet would limit the cash proceeds to Pacific's immediate needs (R. 90–91, 239–240). The

remainder of the Northwest stock would be sold to Pacific's shareholders "by one or two subsequent offerings timed to meet [Pacific's] needs for additional capital," probably within a three-year period (R. 91).

On January 27, 1961, when the plan was proposed to Pacific's Board of Directors (R. 236), Pacific's problems in setting the sales price were explained to the Board of Directors in the following terms (Exhibit 15–0; R. 49, 91):

> The situation differs from that we have had before where the company was offering additional shares of Pacific's own stock. Here, the company will be offering to sell to its shareholders stock of a subsidiary company; in effect, it will be selling a portion of its assets. When you sell an asset the normal tendency is to sell at the highest price possible so as to protect the interests of the debenture holders, preferred shareholders and others. At the same time, the higher the price the more taxes we may have to pay on the excess of selling price over book value. A lower price would produce higher rights values and should result in a broader distribution of the stock among our shareholders. Even here, higher rights values may not be popular with some of our shareholders because they may be ruled to be taxable income, as opposed to rights to our own shares which generally receive capital gains treatment.

Consequently, the selling price was left to be determined by Pacific's board of directors "just before the date of each offering * * *" (R. 92; see, also, R. 128–132).

The plan was submitted to Pacific's shareholders

a month later (R. 74, 100). The proxy statement described the plan, and advised that "promptly" after Pacific acquired the Northwest stock, Pacific would "offer for sale about * * * 56% of such stock," through the issuance to Pacific's shareholders of rights, and that "It is expected that within about three years" Pacific "by one or more offerings will offer for sale the balance of such stock, following the procedures" of the first sale (R. 108–109). The purpose of the later sale would be "to repay advances then outstanding and for general corporate purposes * * *." (R. 109.) The price of the Northwest stock would "be determined by the Board of Directors of [Pacific] at the time of each offering." (R. 109.) Shareholders were told that "Taxable income * * * may result" to Pacific shareholders with respect to their receiving rights to purchase the shares of the new company, and stated that a ruling was being sought from the Internal Revenue Service (R. 112).[1]

Pacific's shareholders approved the plan at Pacific's annual meeting on March 24, 1961 (R. 241). All of the A.T. & T. stock (R. 111) and an overwhelming majority of the minority stock was voted in favor of the plan (R. 49–50).[2]

[1] The proxy statement stated that "[i]n the opinion of counsel" for Pacific, the exchange between Northwest and Pacific would be tax free (R. 111). No comparable statement was made regarding the tax consequences to Pacific's shareholders of their purchasing the stock of the new company.

[2] 97.19 percent of all stock voted "yes"; only 0.12 percent of the outstanding stock voted against. Some 2,977,335 shares were not voted. This accounted for 2.69 percent of the voting strength of Pacific (R. 49–50).

Pacific transferred to Northwest its assets and liabilities in Oregon, Washington and Idaho, and ceased operation of its business in those States at the close of business on June 30, 1961; Northwest commenced operations as of July 1, 1961 (R. 52–54, 243–245). On August 25, 1961, Pacific's board undertook to sell enough Northwest stock to give A.T. & T. a majority of the total shares. The Board approved the proposal of management to offer the stock for sale at $16 per share (R. 56–57, 128–132, 245–246, 248). Although the market price of the Northwest stock was expected to range between $22 and $27.50, the lower price of $16 was selected for two reasons: first, it was desired to issue Pacific's shareholders transferable rights that could be sold, if not exercised, "Since many of our shareholders consider rights values to be in the nature of additional dividends * * *" (R. 130). Second, that price would allow Pacific to pay off the outstanding advances from A.T. & T., and leave it with $34,000,000 cash, which could be used in about two months (R. 132). At the same time, this price minimized the taxes that Pacific itself would be required to pay on the amount by which the proceeds from the sale exceeded Pacific's basis in the Northwest stock (R. 131).

On September 29, 1961, Pacific issued to its common stockholders one right, evidenced by a transferable warrant, for each outstanding share of Pacific's stock (R. 245). The minority holders of Pacific preferred received seven rights for each share of preferred owned. Rights had to be exercised by October 20, 1961. Six rights and payment of $16 were required to purchase one share of Northwest stock. (R. 246.) At that time, the fair market value of the Northwest

stock was more than $26 per share (R. 139).[3] The rights covered some 57.3 percent of the Northwest stock (R. 245).

The prospectus distributed to Pacific's shareholders described the terms and conditions of the sale, and gave instructions for exercising or selling the rights (R. 117–122). The document advised that the Internal Revenue Service had ruled that shareholders who sold or exercised the rights would realize ordinary income in the amount of the sales price or the amount by which the fair market value of the Northwest stock at the time of exercise exceeded the $16 per share purchase price (R. 122–123). The shareholders were reminded that the offering was "the initial offering under the plan" to offer to sell, within about three years, the Northwest stock to the shareholders of Pacific at prices to "be determined at the time of the offering" (R. 125).

On June 12, 1963, the remaining 43 percent of Northwest stock was offered to Pacific's shareholders by a similar issuance of stock rights, on terms requiring eight rights and payment of $16 to acquire one share of Northwest Stock (R. 251–252).

Mr. and Mrs. Gordon, respondents in No. 760, and Mr. and Mrs. Baan, petitioners in No. 781 (collectively the "taxpayers"), were shareholders of Pacific who

[3] The market value of Northwest stock fluctuated between $26 and about $29.81 per share from September 14 to October 20, 1961. In the same period, the market value of each stock right ranged from approximately $1.65 to $2.23. Both the stock and the rights were traded on the American Stock Exchange (R. 247).

received rights in September 1961. On October 5, 1961, the Gordons exercised 1,536 of the 1,540 rights issued to them, acquiring 256 Northwest shares for $4,096 (R. 247). On that day, the average price of the Northwest stock on the American Stock Exchange was $26 (R. 139). On the same day, the Gordons sold their four unexercised rights for $6.36 (R. 247). On October 11, 1961, the Baans exercised all 600 rights issued to them, paying $1600 to acquire 100 shares of Northwest stock. (R. 246–247.) On that day, the average trading price of the Northwest stock was $26.94 (R. 139).

Neither the Gordons nor the Baans reported income on the receipt or exercise of the rights to acquire Northwest stock at less than fair market value (R. 68–69). Nor did the Gordons report the $6.36 received on the sale of four rights (R. 69).

The Commissioner determined that there was a deficiency owed by taxpayers for the year 1961 on the ground that, with respect to the rights which were exercised, they received a dividend measured by the difference between the fair market value of the Northwest stock on the date of exercise and the option price paid for each share of the Northwest stock (R. 26, 228, 253, 256).[4] In the Tax Court the Commissioner further alleged that the Gordons realized ordinary in-

[4] Only the notice of deficiency issued to the Gordons is printed in the consolidated appendix (R. 23–26) as it is representative of the Commissioner's determination for all of Pacific's shareholders who received rights, including the Baans (see R. 253). The issue presented to the Tax Court as to the rights that were exercised was identical for the Gordons and Baans (R. 255–256).

come on the amounts realized upon their sale of four rights (see R. 28, 29).[5] Pacific had sufficient accumulated earnings in 1961 to cover dividends in the total amounts that the Commissioner maintained were taxable as to all Pacific shareholders who exercised or sold rights in 1961 (R. 232).

In consolidated proceedings for redetermination of deficiencies, the Tax Court sustained taxpayers' position that the basic transaction qualified for tax free treatment under Section 355 of the 1954 Code, holding taxpayers need not recognize any gain in connection with the rights they exercised. The Tax Court went on to hold, however, that gain realized by the Gordons upon the sale of rights was taxable as a dividend (R. 256–271), thus rejecting their claim that the gain was capital in character.

Two appeals were taken by the Commissioner. In the *Baan* case, the Ninth Circuit held that the transaction did not meet the requirements of Section 355, and reversed the Tax Court (R. 308–333). In the *Gordon* case, the Second Circuit sustained the Tax Court's view that no gain need be recognized as to exercised rights, but concluded that the gain realized on the sale of rights was capital in nature, and consequently reversed on the latter issue (R. 275–296). Judge Friendly dissented on both issues (R. 297–305).

---

[5] It does not appear that the Commissioner originally determined a deficiency in respect of the rights the Gordons sold; nor does it appear that he had knowledge of the sale (See R. 26). In the Commissioner's answer to the Gordon's petition in the Tax Court, however, he did assert a deficiency, as stated in the text, pursuant to Section 6214(a) of the 1954 Code (R. 28, 29).

SUMMARY OF ARGUMENT

Section 355 of the Internal Revenue Code of 1954 is the latest of a series of tax provisions that over the years have alternatively denied and then granted nonrecognition or "tax-free" treatment to certain spin-off transactions. The general purpose of the statute is to avoid tax impediments to the break-up of business organizations into smaller entities. The intricate and interrelated requirements of the section are a statutory guarantee that tax-free treatment is available only when the break-up is achieved by passing control—in the sense of 80-percent stock ownership—of a subsidiary directly to the shareholders of the parent without changing their investment position. In this way the statute is a special corollary of Code provisions designed to treat as capital transactions divestments amounting to a "genuine contraction" of the original corporate enterprise. Pacific's transaction in Northwest stock served neither of these general purposes. Further, the manner in which Pacific disposed of its Northwest stock failed, in three independent ways, to qualify for the exception Section 355 grants to the general rule that a distribution of corporate property is a taxable event.

First, the statute requires the parent to "distribute * * * solely stock" of the subsidiary. Here Pacific distributed only rights, evidenced by warrants—an option to buy stock. This Court held in *Helvering* v. *Southwest Corp.*, 315 U.S. 194, that such options are not "stock." Congress has in a variety of provisions of the 1939 and 1954 Codes shown its understanding and agreeement with the view that "stock" and "rights" are separate and distinct concepts. It is, in addition,

clear from the rationale of *Palmer* v. *Commissioner,* 302 U.S. 63, 71, and *Commissioner* v. *LoBue,* 351 U.S. 243, that the distribution of rights to buy stock at less than fair-market value is a distribution of corporate property that, to a shareholder, is a dividend to the extent of accumulated corporate earnings and profits.

Second, Pacific failed in several ways to adhere to the requirement of Section 355(a)(1)(A) that it "distribute * * * to a shareholder, with respect to its stock," the Northwest stock. The Northwest stock was available to whomever had the necessary rights and cash, whether or not they were shareholders of Pacific. The requirement of cash consideration is alone enough to disqualify the transaction, since the phrase "distribution with respect to stock" is repeatedly used in the 1954 Code to refer to transfers of corporate property to persons solely because of their status as shareholders. The $16 price also meant that as a practical matter a substantial amount of the Northwest stock would not be expected to be—and in fact was not—transferred to persons who were also shareholders of Pacific.

To treat the cash consideration as a contribution to capital, as the Second Circuit did, would be inconsistent with commonly accepted notions of sales, and would be inconsistent with the established tax treatment of sales of corporate property. Moreover, the result of the cash consideration was that there was not the "genuine contraction" of the corporate enterprise that Congress evidently expected to occur in transactions qualifying under Section 355, since the

cash in large measure replaced Pacific's business in Oregon, Washington and Idaho.

Third, Pacific disposed of only 57 percent of the Northwest stock in 1961, the only taxable year in issue here, and was under no obligation to distribute any part of the remainder at any time. This state of affairs simply does not comply with the obvious intendment of the requirement of Section 355(a)(1)(D) that at least 80 percent of the subsidiary's stock be disposed of at one time. If more than one distribution is to be allowed, it then becomes impossible to administer a variety of the provisions of Section 355, which require that certain events occur or states of facts exist "immediately before", "immediately after", or "throughout the 5-year period ending on the date of" the distribution. It would in addition have been impossible, in 1961, to determine the tax consequences of Pacific's sale of the Northwest stock, even though that determination had to be made to comply with the general scheme that income taxes be measured and reported annually.

Further untoward consequences of a ruling that the split distribution here qualifies under Section 355(a)(1)(D) would be that those persons who were Pacific shareholders in September 1961 would not necessarily receive the later distributed stock, even though Section 355 contemplates a transaction whereby a parent corporation distributes control of a subsidiary to those persons who, as shareholders, represent a unity of interest in the corporation; that it would not be possible to find the genuine contraction of the business

enterprise that Congress contemplated, and it would allow a corporation to make several distributions of a subsidiary's stock at less than fair market value, with the same effect as a dividend, so long as it had some other business objective as its "principal purpose." Pacific, for example, could have done this by having the same overall financial objectives as it had in this case and selling the Northwest stock at the same $16 price in eight equal quarterly installments, beginning and ending on the dates of its actual 1961 and 1963 offerings.

A distinct issue is the proper treatment of the amounts the respondents in No. 760 realized when they sold some of their rights to buy Northwest stock. Those amounts are dividend income if the Pacific transaction fails to qualify under Section 355.

The same result should follow even if Section 355 does apply to Pacific's transaction in Northwest stock. Under the plain terms of the 1954 Code, the distribution of the rights was a distribution of Pacific's corporate property that must be taxed as a dividend, at the market value of the rights on the day they were distributed, unless an exception is found in some Code provision. But Section 355 grants nonrecognition treatment only to a "shareholder * * * on the receipt of the * * * stock" in the subsidiary. Those who sold their rights never received the Northwest stock represented by those rights, and therefore cannot qualify for the exception.

ARGUMENT

INTRODUCTION

This case turns on the construction and application of Section 355 of the Internal Revenue Code. This is a long and highly integrated provision, the full text of which is set forth in the Appendix (*infra*, pp. 53–56).

In applying the statute to this case, three specific questions of construction primarily arise:

1. Section 355(a)(1)(A) provides that the section will be applicable when "a corporation * * * distributes to a shareholder, with respect to its stock * * * solely stock or securities of a corporation * * * which it controls immediately before the distribution." The question is whether the distribution of rights by Pacific constituted a distribution of "solely stock or securities."

2. Under the rights distributed by Pacific, the recipient, or his transferee, was required to make payment of cash before he could receive Northwest stock. The question is whether the Northwest stock, so offered for purchase, comes within the statutory language, which applies only where a corporation "distributes to a shareholder, with respect to its stock." Is this a distribution, or is it a sale? If it is to be regarded as a distribution, but as a distribution of the excess in value of the Northwest stock over the purchase price required for the exercise of the rights, can such a distribution be said to be a "distribution" of the Northwest stock itself? If it is a

distribution of the Northwest stock, "with respect to" what has it been made—the stock of Pacific or the chose in action represented by six rights and $16? And to whom has it been made; can it be to "a shareholder" of Pacific even though any person could have bought the necessary rights on the stock exchange?

3. During 1961, the tax year here in question, Pacific sold only 57 percent of the Northwest stock. Section 355(a)(1)(D) of the Internal Revenue Code provides that the section is applicable where "as part of the distribution, the distributing corporation distributes" stock amounting to control, which, under the terms of Section 368(c) of the Code requires 80 percent of the stock of Northwest. The question is whether a disposition of 57 percent of the stock in 1961 can be regarded as coming within the proper construction of this provision, where the remaining 43 percent was disposed of 21 months later in a transaction which was in no way obligated at the time the first offering was made. Can an offering of 57 percent of stock, with no further obligation, constitute disposition of "control" when that term is specifically defined as requiring "at least 80 percent" of the voting stock?

In considering the construction of Section 355, it may be helpful to put the statute in its setting. The general type of transaction involved here has been called a "spin-off," although we do not think that the actual transactions here were a spin-off, since (1) it involved a sale of stock, rather than a distribution, and since (2) only 57 percent of the stock of North-

west was disposed of, the balance being retained by the parent company for a further 21 months.[6]

The first provision in the tax laws allowing tax-free treatment of spin-offs was enacted in 1924. Section 203(c) of the Revenue Act of 1924, c. 234, 43 Stat. 253, 256–257, provided that no gain or loss would be recognized if a corporation distributed shares after transferring some or all of its property to a second corporation, and the first corporation or its shareholders had at least 80 percent of the shares of the second corporation. It became apparent, however, that Section 203(c) could lead to widespread tax avoidance.[7] Congress in 1934, therefore, repealed the provision. See Revenue Act of 1934, c. 277, 48 Stat. 680.

For the next 17 years, a spin-off was treated as a dividend to the extent that the fair market value of the stock received by shareholders reflected earnings and profits of the distributing corporation. It mat-

---

[6] Congress in 1951 said, "A spin-off occurs when a part of the assets of a corporation is transferred to a new corporation and the stock in the latter is distributed to the shareholders of the original corporation * * *." S. Rep. No. 781, 82d Cong., 1st Sess., at p. 57.

[7] For example, cash or other liquid assets could be transferred to a new corporation, and its shares distributed to the shareholders of the transferring corporation. Then, under the literal terms of the statute, the new corporation could be liquidated at capital gains tax rates. See *Parshelsky's Estate* v. *Commissioner*, 303 F. 2d 14, 17–18, 20 (C.A. 2); *Commissioner* v. *Wilson*, 353 F. 2d 184, 186 (C.A. 9). Taxpayers attempted to proceed in just this manner. This Court ruled in *Gregory* v. *Helvering*, 293 U.S. 465, after the repeal of the 1924 Act, that such a transaction should be treated as a dividend even for years when the 1924 Act was in force.

tered not that a particular spin-off may have served a legitimate business need or was untainted by tax-avoidance objectives.

In 1951, Congress added Section 112(b)(11), 65 Stat. 452, 493, to the Internal Revenue Code of 1939 to provide nonrecognition treatment to some spin-offs. This time the statute was more carefully safeguarded. Like the 1924 Act, the 1951 amendment allowed tax-free treatment of spin-offs that were accomplished by transferring assets to a second corporation while the first corporation or its shareholders remained in 80-percent control. There was added, however, the proviso that both corporations must "intend * * * to continue the active conduct of a trade or business after such reorganization," and that the new corporation must not be "used principally as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization." The Senate Finance Committee, in recommending the legislation, commented, "[I]t is economically unsound to impede spin-offs which break-up businesses into a greater number of enterprises, when undertaken for legitimate business purposes." S. Rep. No. 781, 82d Cong., 1st Sess., p. 58.

When Congress drafted the Internal Revenue Code of 1954, it undertook to treat the general subject of distributions by corporations to their shareholders in a comprehensive manner that would add certainty to this area of law. It drafted Section 355 to deal with

spin-offs and certain similar transactions.[8] The new statute carried forward the requirements of the 1951 Act, but added several specific and detailed new requirements, thus narrowing substantially the class of transactions that would qualify for nonrecognition. This is the provision which is invoked in this case.

The question on which this case turns is a somewhat intricate and technical one. In the pages which follow we have tried to pursue the technical argument as carefully and thoroughly as possible. It may be appropriate here, therefore, to seek to put the case in its somewhat larger setting.

Congress has, in Section 355 made special provision for corporate "spin-offs." This was done after some thirty years of history, and we know of no reason why the statute should be given a narrow or niggardly construction insofar as it is sought to use it to carry out the objective which Congress had in mind in enacting it. But neither is an unduly expansive reading, one that ignores the "ordinary, everyday senses" of the words, *e.g., Crane* v. *Commissioner,* 331 U.S. 1, 6, needed to attain the legislative objective.

That objective was to facilitate the breaking down of the size of corporate undertakings, as is clearly

[8] Section 355 also applies to "split-offs" and "split-ups", which are similar to spin-offs, in the sense that the stock of a corporate subsidiary is distributed to the parent's stockholders. The difference is that in a split-off the stockholders must surrender part of their stock in the parent, and in a split-up those shareholders receiving stock in the subsidiary surrender all of their stock in the parent. See S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 266–267; Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed.), pp. 450–451.

indicated by the extract from the 1951 Committee Report which is quoted above (p.18, *supra*). The spin-off which Congress had in mind, and to which the language of the statute is clearly directed, is the breaking up of a business into two or more separate entities, with the consequence that the size of the original corporate enterprise is contracted by the genuine separation of its businesses into distinct entities. The shareholders continue to own both, having now more pieces of paper to represent their aggregate ownership than they had before.

Although there was here clearly a "business purpose," so that such cases as *Gregory* v. *Helvering*, 293 U.S. 465, are not directly applicable, there are at least two reasons why the transaction falls outside the basic objective of the "spin-off" statute:

1. It was not a breaking up of a large business venture into two or more separate organizations. On the contrary, it was simply the rearrangement of the existing activity, all within the same corporate control. There was no separation off; there was, indeed, no real "spin-off." Nor can there be any break-up of a business in a spin-off of a subsidiary of a subsidiary to the ultimate parent. Congress thus must have had in mind a spin-off to persons other than a parent of a parent. Perhaps if Congress had foreseen the latter uses of the spin-off, it would have denied tax-free treatment to the extent that a consolidated return is unavailable or minority shareholders are involved. Congress did not do so, and we would not attack Pacific's transfer of the Northwest shares to A.T. & T. and the minority rights holders if the transaction

complied with the several conditions of Section 355. But where, as here, Pacific, in order to obtain its own unique business purposes, chose not to follow several of the statutory commands, a judicial relaxation of the statute would in no manner achieve Congress's underlying objectives.

2. It was not an outright distribution of shares to shareholders. Even ignoring A.T. & T. as the common parent, there was no genuine contraction of the Pacific business enterprise. On the contrary, the disposition of the Northwest shares was a part of an elaborate refinancing operation, through which, in effect, Pacific sold, at a small discount, its Washington, Oregon and Idaho assets to its shareholders, and used the proceeds to pay back money which it had borrowed to finance its expansion over the prior year or two, and to provide itself with capital for further expansion. These were wholly legitimate objectives, but they were not the sort of transaction which Congress had in mind when it provided that no income would be recognized when a corporation "distributes" to its shareholders stock which constitutes "control" of a subsidiary corporation.

Here, though in a quite different way, Pacific and its shareholders seek to "use" the statute quite as much as its predecessor was used by Mrs. Gregory, the taxpayer in *Gregory* v. *Helvering, supra.* Indeed, Pacific found the way that would provide no tax for its parent A.T. & T., and very little tax for itself. It did not obtain a ruling from the Treasury that its outside shareholders would not be taxable, and so advised

292-249—68——4

these shareholders. Nevertheless, it, and they, went ahead.

Where a taxpayer is trying to carry out an objective established by Congress, the statute may well be given a broad, and, indeed, a generous construction. Where the taxpayer's objective, however, is to obtain a result quite different from that which Congress had in mind in enacting the statute, there is no reason why the statute should not be read as it is written, and construed to exclude the taxpayer who does not come within its highly articulated terms. This is the policy approach which we would suggest in this case, and which may well serve as background for the technical argument which follows. In the *Gregory* case, the taxpayer brought herself within the literal language of the statute, but the Court held that the statute should not be construed to apply to her case since the transaction she carried out did not come within the objectives intended by Congress. It was verbally, but not truly, a "reorganization"; it was not the sort of "reorganization" that Congress contemplated when it wrote the statute. Here the transaction is not literally within the ambit of the statute, for reasons which we develop further below. But, in addition, it is not within the purpose or objective of the statute, since the transaction here was not a true "spin-off," not the sort of distribution that Congress had in mind when it enacted the statute. In some cases, it may be wise and appropriate to give statutory language a broad construction, in order to facilitate carrying out its intended purpose. Where, as here, though, the practical result sought to be reached is not within the gen-

eral scope or objective of the statute, there is no reason for going beyond the terms of the statute as Congress has written them.

We now turn to a specific examination of the application of the statute to the facts of this case. Our argument is presented in terms of the three problems of statutory construction presented at the beginning of this Introduction (pages 15–16, *supra*).

I. PACIFIC DID NOT DISTRIBUTE "SOLELY STOCK OR SECURITIES" OF NORTHWEST

Section 355(a)(1)(A) provides that if there is to be nonrecognition of gain, the parent corporation—here Pacific—must "distribute to a shareholder, with respect to its stock * * * solely stock or securities of" a controlled subsidiary—here Northwest. In fact, Pacific distributed only rights evidenced by transferable warrants. These rights or warrants are not stock, but simply a privilege to buy stock—an option to purchase Northwest stock at a fixed price binding on the seller but not on the buyer.[9]

It has been clear ever since the decision in *Helvering v. Southwest Corp.*, 315 U.S. 194, 200–201, that stock warrants are not "stock." There, in considering the meaning of the phrase "voting stock" in

---

[9] There is no claim that "securities" were distributed. If the rights were "securities," nonrecognition treatment would be unavailable by reason of the provisions of Section 355(a)(3)(B), which denies such treatment to the distribution of securities if, as here, no "securities" were "surrendered."

Section 112(g), the reorganization provisions, of the Revenue Act of 1934, the Court said:

> [A] warrant holder * * * is not a shareholder. * * * His rights are wholly contractual. As stated by Holmes, J., in *Parkinson* v. *West End Street Ry Co.*, 173 Mass. 446, 448, 53 N.E. 891, 892, he "does not become a stockholder by his contract in equity any more than at law." At times, his right may expire on the consolidation of the obligor corporation with another. *Id.* If, at the time he exercises his right, there are no authorized and unissued shares to satisfy his demand, he will get damages, not specific performance. * * * Thus, he does not have, and may never acquire, any legal or equitable rights in shares of stock. * * * And he cannot assert the rights of a shareholder. * * * [Citations omitted.]

Congress has shown its awareness of and its agreement with this rule in adopting special legislation, Section 373 of the 1939 Code, now Sections 1081-1083 of the 1954 Code, to permit tax-free distributions of stock and securities in a divestiture ordered by the Securities and Exchange Commission. There, Congress specifically defined "stock and securities" for such purposes to include stock rights and stock warrants, recognizing that it was giving the phrase a broader meaning than it ordinarily had (S. Rept. No. 1567, 75th Cong., 3d Sess., pp. 36-37):

> In order to facilitate exchanges or distributions in furtherance of the policies of section 11(b) of the Public Utility Holding Company Act of 1935, the term "stock or securities" is given a broader meaning in section 373(f) than

it possesses in connection with the reorganization provisions of section 112 [1939 Code]. It is defined to mean stock or other certificates of interest in a corporation on the one hand, and notes, bonds, debentures, and other evidences of indebtedness, whether of a corporation or an individual, on the other. Since voting trust certificates, stock rights or warrants, etc., are merely evidences of the ownership or the right to acquire more direct interests, such instruments are also included.

The same point appears from several sections of the 1954 Code. In Section 305(a) Congress codified the rule that this Court established in *Eisner* v. *Macomber*, 252 U.S. 189, that a distribution of a corporation's own stock is not "income." The statutory language is:

> Except as provided in * * * [Section 305(b)], gross income does not include the amount of any distribution made by a corporation to its shareholders, with respect to the stock of such corporation, *in its stock or in rights to acquire its stock.* [Emphasis supplied.]

A parallel clause in Section 317(a)—which defines generally the word "property"—provides that "'property' * * * does not include stock in the corporation making the distribution (or rights to acquire such stock)." Section 311(a)(1), in defining the effect of various corporate distributions on the corporation, in similar manner speaks of the corporation's "stock" and "rights to acquire its stock" as separate categories. Surely, then, Congress viewed "rights to acquire stock" as something other than "stock."

The Second Circuit majority did not rule that stock

"rights" are the equivalent of "stock or securities." Rather, relying on *Palmer* v. *Commissioner*, 302 U.S. 63, and *Choate* v. *Commissioner*, 129 F. 2d 684 (C.A. 2), it held that (R. 286):

> * * * the distribution of a stock right has no tax consequences because there is no distribution of corporate property until the right is exercised. * * * [I]t is the actual distribution of the Northwest stock upon the exercise of the rights that is the relevant event and the use of the stock rights as a mere mechanism to accomplish this result should be disregarded.

Of course, were the Second Circuit correct in asserting that the issuance of rights is merely "a mechanism" for the distribution of stock, this Court would have reached a quite different result in *Helvering* v. *Southwest Corp., supra.* See the Ninth Circuit's opinion in *Baan,* at R. 319–320.

Palmer and *Choate* do not, in any event, hold that the issuance of rights to acquire the stock of another corporation and their subsequent exercise may be telescoped into a single event. As Judge Frank's analysis of *Palmer* and *Choate* makes clear, 129 F. 2d at 686–687, those cases decide—under the pre-1954 statutes—only the date to be used in determining whether the issuance of rights results in income to the stockholders receiving them—the date when the rights are issued or the later date when they are exercised. The Court's observation in *Palmer* (302 U.S. at 71) that the "mere issue of rights to subscribe and their receipt by shareholders, is not a dividend" must be read in light of the fact that in *Palmer* there was no spread between the option price

and the fair-market value of the offered stock at the time the rights were issued, although the market value was above the option price on the day of exercise.

Any relevance of *Palmer* in this case is in the comments this Court directed at the situation—such as the one here—where the price of corporate property to shareholders is lower than the market value on the day of issuance (302 U.S. at 69):

> On the other hand, such a sale, if for substantially less than the value of the property sold, may be as effective a means of distributing profits among stockholders as the formal declaration of a dividend. * * * and such a transaction may appropriately be deemed in effect the declaration of a dividend, taxable to the extent that the value of the distributed property exceeds the stipulated price. * * *

This Court, moreover, made clear in *Commissioner* v. *LoBue,* 351 U.S. 243, that a *transferable* right having a readily ascertainable value—such as are involved in this case—is assuredly "property" the distribution of which may in itself be ordinary income. There the question was whether an employee who received a non-transferable option to acquire, at less than fair-market value, stock of his employer corporation should be taxed at the time the option was exercised rather than at the time it was issued. The decision that the tax was to be measured by the difference between the option price and the value at the time of exercise rested on the fact that the option had no readily ascertainable market value when issued because it was then contingent and not transferable. The Court noted, however (351 U.S. at 249):

> It is of course possible for the recipient of a stock option to realize an immediate taxable gain. See *Commissioner* v. *Smith,* 324 U.S. 177, 181–182. The option might have a readily ascertainable market value and the recipient might be free to sell his option. But this is not such a case. * * *

The present litigation is, in contrast, "such a case." The rights Pacific issued in Northwest stock had value; they were traded on the stock exchange on a "when issued" basis as early as September 14, 1961, six days before the rights were distributed to Pacific's shareholders. (R. 140.) And Pacific's management, in formulating its 1961 transaction in Northwest stock, expressly "contemplate[d] reasonable rights values." (R. 130.)

The 1954 Code itself further supports the conclusion that a distribution of transferrable rights to acquire corporate property at less than fair market value is taxable. Section 317(a) defines "property", for purposes of the provisions dealing with taxable corporate distributions, as "money, securities, and any other property"; it excepts solely "stock in the corporation making the distribution (or rights to acquire such stock)" in order to conform to the codification of the rule of *Eisner* v. *Macomber, supra,* in Section 305(a). Section 317's broad definition of property plainly includes stock of a second corporation and rights to acquire that stock. Pacific's distribution of transferrable rights to acquire the Northwest stock was necessarily a distribution of property and not an event that may be ignored as a mere

"mechanism." See, generally, Carlson, *Taxation of "Taxable" Stock Rights: The Strange Persistence of Palmer v. Commissioner*, 23 Tax L. Rev. 129; Whiteside, *Income Tax Consequences of Distributions of Stock Rights to Shareholders*, 66 Yale L. J. 1016. But it was not a distribution of "stock" in Northwest. The Pacific shareholder could receive Northwest stock only by making a substantial payment to Pacific. When Pacific thereupon transferred Northwest stock to its shareholder, it was a sale, not a distribution. The Pacific shareholder did not receive "solely stock or securities" from Pacific, as Section 355(a)(1)(A) requires.

II. PACIFIC DID NOT "DISTRIBUTE TO A SHAREHOLDER WITH RESPECT TO ITS STOCK" THE NORTHWEST STOCK

A. THE INTERNAL REVENUE CODE CONSISTENTLY USES THE PHRASE "DISTRIBUTE WITH RESPECT TO STOCK" TO REFER ONLY TO DISTRIBUTIONS TO SHAREHOLDERS WITHOUT CONSIDERATION

When the stock rights issued to Pacific's shareholders were exercised, Pacific did not "distribute to a shareholder with respect to its stock" the Northwest stock, as required by Section 355. Rather, it sold the Northwest stock to whomever had six rights and $16. The rights themselves were transferable and, a purchaser of the Northwest stock through exercise of the rights may or may not have been a Pacific shareholder. If a purchaser was a Pacific shareholder, he may have received his rights "with respect to" his stock in Pacific; he might, however, have bought some of his rights on the stock exchange from some other shareholders who, like respondents in No. 760, sold

rights. Persons who were not Pacific shareholders could also have bought the rights. Anyone who did buy rights received Northwest stock only "with respect to" rights plus $16, and not "with respect to" stock of Pacific.

The phrase "distribution * * * with respect to * * * stock" is a term of art with a consistent meaning throughout the Internal Revenue Code. It is always used to refer to distributions without consideration, and never refers to sales. Section 305 thus makes tax-free a "distribution * * * with respect to the stock of such corporation" of "its stock or * * * rights to acquire its stock." Section 301 uses the phrase in establishing the basic rule that a dividend is taxable as ordinary income. Section 307 uses it in describing the basis of distributed property in the hands of the recipient shareholder, and Section 312 does so in determining the effect of a distribution of corporate property on the company's earnings and profits. All of these sections deal with circumstances where someone receives some corporate asset solely because of his status as a shareholder, and without providing or paying any consideration.

Section 311(a) may demonstrate most clearly of all that the phrase "distribute * * * with respect to its stock" precludes a transaction in which the corporation receives consideration from its shareholders. Section 311(a)(2) states as a general rule that a corporation shall not recognize any gain or loss in a "distribution, with respect to its stock * * * of property." Such treatment is, however, plainly inconsistent with the view that a "distribution with

respect to its stock" could include a sale, for on a sale the corporation must recognize gain to the extent that the purchase price exceeds the adjusted basis of the property. See Sections 1001 and 1002 of the 1954 Code. In addition an exception to the general rule, established in Section 311(c), provides that upon a corporate "distribution with respect to its stock of * * * property" subject to a liability in excess of the corporation's adjusted basis in the property, "gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of distribution." This is a specific application of the general rule that an assumption of liability is treated as a payment of money. *E.g., Crane* v. *Commissioner,* 331 U.S. 1, 12–14. This exception would have been unnecessary if the phrase, "distribution with respect to its stock", includes a sale. If the words do comprehend a sale, Congress would hardly have used in Section 311(c) the phrase, "as if the property distributed had been sold at the time of the distribution."

B. VIEWING THE $16 CASH CONSIDERATION AS A CONTRIBUTION TO THE CAPITAL OF PACIFIC WOULD BE INCONSISTENT WITH COMMONLY ACCEPTED IDEAS OF WHAT CONSTITUTES A SALE AND ITS TAX CONSEQUENCES

In rejecting the Commissioner's contention that a "distribution with respect to * * * stock" cannot describe a transaction requiring the shareholder to pay a cash consideration, the Second Circuit acknowledged (R. 286–287):

> It is perfectly obvious that the Code does not contemplate the receipt of cash by a corporation

> in connection with a distribution with respect to its stock in the sense that some specific section of the Code spells out the tax result. See Sections 311(a) and 312(d). But it scarcely follows that the Code prohibits the receipt of cash * * *.

Having thus disposed of the statutory pattern of using the phrase "distribution with respect to * * * stock" only in circumstances where a sale is not intended, the Second Circuit majority viewed the transfer of Northwest stock from Pacific to holders of the stock rights as an event separate from the payment of the $16 consideration by the holders of those rights. It adopted the reasoning of the Tax Court that (45 T.C. 71, 90; R. 285):

> [i]f Congress had intended that a distribution of the Northwest stock be treated as tax free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection with receiving such stock. * * * [Emphasis in original.]

The Second Circuit suggested (R. 287) that the payment of the $16 "can be treated very simply as a contribution to capital by a shareholder."

This analysis, to begin with, ignores the reality of what happened. There is nothing in this record to show that any of Pacific's shareholders would have invested cash in Pacific apart from the *quid pro quo* of Northwest stock. This is especially true of those who bought Northwest stock after buying rights on the stock exchange. This latter group was considerable.

(See p. 35 *infra.*) Thus, the transaction must be taken as it stands—an exchange of property for cash. And, as such, it must be denominated as would any such transaction—by the word that Pacific itself used to describe what it was doing, a "sale" (R. 117, 118).

The characterization of the cash payment as "a contribution to capital" creates problems that the Second Circuit recognized, but ignored as "not before us" (R. 287 and n. 5), relating to the proper treatment of the transaction from Pacific's standpoint. Pacific, in treating the transaction as a sale of property, reported gain measured by the excess of the amount of money it received for Northwest stock and the lesser basis that the Northwest stock had in Pacific's hands.[10] Under Section 118 of the Code, however, a "contribution to capital" is expressly excluded from the corporation's gross income. Therefore, under the Second Circuit's analysis Pacific should be entitled to a refund of the taxes it paid, on the ground that the transaction was not a sale, but was simply two separate transactions, a distribution of property and a contribution to capital. If this is so here, it presumably would also be true in any other case where a corporation sells its property at a profit to its shareholders. Any such transaction can be separated into two parts, as the Second Circuit did here; a distribution of property, and a

[10] The use of consolidated returns eliminated that portion of the gain represented by A.T. & T.'s exercise of the rights issued to it. There still remained some $8,700,000 of taxable gain on the sales of Northwest stock to others than A.T. & T. (R. 248) and an additional amount was presumably reported as a result of the sale of the remaining 43 percent of the Northwest stock in 1963.

contribution to capital.[11] There is no precedent for such an analysis in any of the reported cases. Plainly such a departure from the commonly accepted idea of "sale" should not be adopted "absent congressional guidance in this direction." *Commissioner* v. *Brown*, 380 U.S. 563, 575.

C. THE REQUIREMENT OF CONSIDERATION IS INCONSISTENT WITH THE STATUTORY PROVISION THAT THE DISTRIBUTION BE TO THE PARENT'S SHAREHOLDERS

The requirement of Section 355(a)(1)(A) that the "distribution" be to the corporation's "sharehold-er[s]" reflects the general rationale underlying the reorganization provisions of the Code—that merely a change in corporate form has occurred when the shares of the two corporations resulting from the separation of one are owned by the same persons who were the shareholders of the original enterprise. The very issuance of transferable rights means that the

[11] An added difficulty with the Second Circuit's analysis lies in the computation of the basis of the Pacific and Northwest stock. If the $16 is a contribution to Pacific's capital, it should be added to the contributor's basis in Pacific stock, see Section 1012 and Section 1016(a)(1) of the 1954 Code; Treas. Reg. Secs. 1.118–1, 1.263(a)–2(f); even though it is plainly part of the cost of the Northwest stock. Then, what would be the result to those who owned no Pacific stock, but purchased rights to the Northwest stock? And how would all this be squared with the requirements of Sections 358(a), (b) and (c) that in a transaction that comes within the terms of Section 355, the shareholder's basis in the parent's stock be allocated in part to the subsidiary's stock that the shareholder receives?

people receiving the Northwest stock will not necessarily be the same ones who, as shareholders of Pacific, received the rights to buy the Northwest stock. Pacific intentionally made it easy for the rights to be sold, explaining in its prospectus how such sales were to be made (R. 120–121). The requirement of a $16 payment made sales particularly likely. As the Ninth Circuit reasoned (R. 326), "it could well be that a substantial number of the distributing corporation's shareholders would, under the circumstances of a particular case, choose to sell their stock rights rather than to themselves make the cash payment which exercise of the stock rights would entail."

That in fact happened. Individuals, trustees and nominees bought 975,884 shares, only some five-eighths of the amount for which they received rights (R. 141), indicating they had sold rights to about 570,000 shares.[12] Brokers as a class, in contrast, used the rights to purchase 613,789 shares of Northwest—more than quadruple the number of shares for which brokers, as shareholders of Pacific, received rights thus indicating that they or their clients had bought rights to about 470,000 shares.

D. THE REQUIREMENT OF CONSIDERATION IS INCONSISTENT WITH CONGRESSIONAL INTENTION THAT A TAX-FREE SPIN-OFF RESULT IN A GENUINE CONTRACTION OF THE ORIGINAL CORPORATE ENTERPRISE

The very nature of a cash payment, moreover, took Pacific's transaction outside the intended ambit of Section 355, because there then could not be a real contraction of the Pacific enterprise. The justification

[12] 80,759 rights representing some 13,400 shares were allowed to lapse (R. 141).

for providing nonrecognition treatment to spin-offs coming within the terms of Section 355 lies in the fact that such transactions would be partial liquidations taxable at capital-gains rates under Section 331(a)(2) and 346(a)(2) and (b) of the 1954 Code, but for the facts that stock rather than other property is "distributed" and that no stock of the distributing corporation is redeemed. In the partial-liquidation provisions, Congress has sought to tax as capital gains, rather than ordinary income, corporate distributions that amount to "a genuine contraction of the business" of the company. S. Rep. No. 1622, 83d Cong., 2d Sess., p. 262; see, also, Treas. Reg. Section 1.346-1(a). The partial liquidation provisions deal with the situation where the assets representing the terminated business are distributed directly to the shareholders, an event that requires immediate recognition of gain. In a Section 355 transaction, however, nonrecognition is granted because the business that one corporation terminates continues in another corporate form, and is still owned by the same shareholders. But the similarity of the statutory language[13] shows that in each

[13] In Section 346(b)—the so-called "safe-harbor" provision—Congress established a specific example of a distribution that was an adequate "contraction" to qualify for taxation at capital-gains rates: when "the distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution"; and (Section 346(b)(2)) "[i]mmediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution." Compare the very similar language used in describing

case Congress contemplated the same "genuine contraction" of the original enterprise.

The cash payment here meant that although part of the corporate property was removed from the Pacific enterprise, cash was in a very substantial degree substituted for it. This is not "a genuine contraction" of the business enterprise such as Congress had in mind. Compare Rev. Rul. 67–299, 1967–37 Int. Rev. Bull. 8. Nor is it the sort of "break-up", see p. 18, *supra,* which the 1951 Congress was seeking to encourage when, for the first time since 1934, it allowed tax-free treatment to some spin-offs. If Pacific had sold its assets in Washington, Oregon and Idaho to its shareholders at less than fair-market value, the result would have been a dividend and not a partial liquidation entitled to capital-gains treatment. Treas. Reg. § 1.301–1(j); see *Gibson* v. *Commissioner,* 133 F. 2d 308 (C.A. 2). Statutory language much clearer than that used here should be necessary to give the transaction not only capital status, but the greater benefit of nonrecognition simply because stock representing the assets was sold.

Pacific, as far as this record shows (see R. 240), could have planned its disposition of the Northwest stock so as to "distribute * * * to a shareholder, with respect to its stock" the Northwest stock. For example, it could have distributed the Northwest stock

---

the "active business" requirements a spin-off must satisfy to qualify for nonrecognition treatment. Sections 355(b)(1)(A) and 355(b)(a)(8). See H. Rep. No. 2543, 83d Cong., 2d Sess., p. 38.

directly to the Pacific shareholders without consideration. It consciously chose to do otherwise, for its own reasons, knowing full well that the government would resist any claim of nonrecognition treatment by Pacific's minority shareholders.[14] Federal taxes were a neutral factor, since Pacific's membership in the A.T. & T. complex meant that any tax impact on its major shareholder would disappear on the consolidated return.[15]

It did not suit Pacific's purposes to distribute the stock to its own shareholders without consideration, for it wanted to use the stock as a means of raising the funds to pay off the advances from A.T. & T. and to raise additional capital for use in its California operations. Pacific could also have sold the Northwest stock at market value, a course it recognized as "the normal tendency" (R. 91), in which case its shareholders would have received no gain in the transaction. The record shows, however, that Pacific consciously chose a lower price "[s]ince many of our shareholders consider rights values to be in the nature of additional dividends" (R. 130); and the lower the sales price, the higher would be the rights value.[16]

---

[14] Not only did the Internal Revenue Service rule that the transaction would fail to qualify for nonrecognition, but Pacific's own legal counsel was apparently unwilling, even before receipt of that ruling, to advise to the contrary. See footnote 1, p. 6, *supra*.

[15] But for the consolidated return, A.T. & T. would have realized about $150,000,000 gain if the transaction failed to qualify under Section 355, since it purchased more than 15,000,000 Northwest shares in 1961 (R. 125).

[16] The offering price, moreover, came within one or two percent of the exact figure needed to make the amount paid by

Although a higher offering price would have given Pacific more money, each additional dollar charged for the Northwest stock would have resulted in 30 to 50 cents of taxes (R. 137), a discount Pacific itself was unwilling to pay for the additional capital (R. 131).

The Second Circuit majority, in ruling for the taxpayers, apparently did not conclude that Pacific squarely satisfied all the requirements of Section 355 (a)(1)(A); it did not dispute Judge Friendly's dissenting suggestion, "Certainly the words have an uneasy fit to the transaction here in question." (R. 303.) Rather, it thought it should use "a certain flexibility in applying the Code" and avoid "undermining the general purposes of the Code through an overly literal application of each of its technical provisions * * *." Therefore, it based its ruling in large part on the view that Pacific's transaction "fulfilled a valid business purpose," and did not present "any opportunity for the taxpayers to use this transaction for a bail-out of earnings and profits." (R. 282, 284-285.)

Here the very intricate changes of the statute in 1954, in terms so markedly different from those adopted in 1951, coupled with the prior history of spin-off transactions makes very plain that there was no congressional desire "to have the Commissioner or the courts make a determination in each case as to whether the use * * * was for tax avoidance." *Braunstein* v. *Commissioner,* 374 U.S. 65, 71; cf. *Hanover*

A.T. & T. for the 15,548,140 shares for which it received rights (R. 125) equivalent to the indebtedness of about $245,000,000 Pacific then owed to A.T. & T. (R. 132, 136).

Bank v. *Commissioner,* 369 U.S. 672, 687; *Crane* v. *Commissioner,* 331 U.S. 1, 6. Pacific avoided the requirements of Section 355 that were inconsistent with its own peculiar financial objectives. When it did so, it created a transaction other than the "distribution * * * with respect to its stock * * * solely of stock or securities" that Congress had in mind. As a result, the transaction was one to which nonrecognition of gain should not apply.

III. TWO SEPARATE DISTRIBUTIONS, OF 57 AND 43 PERCENT OF THE STOCK MADE OVER A PERIOD OF 21 MONTHS DO NOT SATISFY THE REQUIREMENT OF SECTION 355(A)(1)(D) THAT THE PARENT DISTRIBUTE AT LEAST 80 PERCENT OF THE VOTING STOCK OF THE SUBSIDIARY

Section 335(a)(1)(D) requires that "as part of the distribution" the distributing corporation—in this case Pacific—have and then part with at least 80 percent of the voting stock of the subsidiary—here Northwest. Although Pacific started with all of the Northwest stock, in 1961—the only taxable year involved in this litigation—it parted with 57 percent. At that time Pacific "expected. that within about three years * * * the Company by one or more offerings will offer for sale the balance of" the Northwest stock (R. 109). As the Second Circuit majority said, "It was left to the sole discretion of the Pacific management, however, to determine the number of offerings of Northwest stock to the Pacific shareholders and the price at which the stock would be made available" (R. 281; see, also, the Ninth Circuit opinion at R. 329–330; see R. 108–109.)

Pacific thus was under no obligation to offer the re-

mainder of the Northwest stock at any point in time. When it did seek to dispose of the remaining Northwest stock, the transaction was as distinct as it was widely-spaced from the 1961 offering.

The language of Section 355(a)(1)(D) contemplates one and not two unconnected distributions of stock. This is apparent from the wording of the Section as a whole. Thus, there are frequent references to things being done "immediately before" or "immediately after" "the distribution". This indicates that Congress contemplated a single "distribution", which would provide a specific date from which certain events may be measured or tests applied. Section 355(a)(1)(D)(i), for example, requires that "all of the stock and securities in the controlled corporation held by [the distributing corporation] * * * immediately before the distribution" be distributed. Section 355(a)(1)(A) requires that the distributing corporation control the subsidiary "immediately before the distribution"; Section 355(b)(1) requires that active businesses be conducted "immediately after the distribution"; Section 355(b)(2)(A), in defining what is meant by "active conduct of a trade or business", again uses the phrase "immediately after the distribution"; the latter section also requires that the trade or business have been "actively conducted throughout the 5-year period ending on the date of the distribution." This requirement is also incorporated into subsections 355(b)(2) (C) and (D).

Thus Congress must have intended that "the distribution" occur in such a way that what occurred "immediately before", "immediate after", and

during the 5-year period "ending on the date of the distribution" can be determined.

These dates can not be fixed when a distribution is spread over an originally indefinite period of time as in this case. Unless the phrase "the distribution" in Section 355(a)(1)(D) be given its plain meaning—that the stock be disposed of in a single transaction—the Commissioner and the courts will be unable to apply with certainty these many requirements.

The contrary result reached by the Second Circuit cannot be squared with the general concept found in every Revenue Act since 1913, that the income tax is to be "uniformly assessed * * * on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period * * *." *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 363. Neither the Commissioner nor the taxpayers here could have determined what the correct tax liability was on this transaction when 1961 had come to a close. They could not know then whether Pacific would ultimately distribute the rest of the Northwest stock or when that final event would occur. Only by waiting until mid-1963 could the tax consequences of the 1961 distribution be determined, if the Second Circuit's result is accepted.

When Congress intended that the tax consequences of a transaction be determined by examining events occurring in more than one taxable year, it has said so explicitly, and has made provision for appropriate adjustments. See Sections 172(b), 381, 382, 1301, 1302, 1303, and 1311. Cf. Section 2055(b)(2). No similar provisions may be found in Section 355.

There is no basis for the Second Circuit's con-

clusion that "neither of the purposes suggested by subsection (a)(1)(D) will be defeated by permitting more than one distribution * * *." The first purpose is that the contraction of the original corporate enterprise be by a spin-off of a distinct "trade or business." See p. 36 and n. 13 *supra.* The requirement that at least 80 percent be distributed "is designed to differentiate between genuine separations and incidental distributions of a controlled corporation's stock which would take the place of current cash dividends." Surrey & Warren, *Federal Income Taxation,* p. 1640 (1960). Plainly there is no event that may be called such a separation if more than one distribution is allowed.

Furthermore, the requirement of section 355(a)(1)(A) that the distributing corporation control the subsidiary "immediately before" the distribution establishes that the distributing corporation will surrender a distinct "trade or business." See Section 355(b)(2)(A). Yet, if the present transaction is allowed to qualify, then Pacific could not have "controlled" Northwest "immediately before" the 1963 distribution of 43 percent of Northwest's stock.

The other principal purpose of Section 355(a)(1)(D) was "to prevent a parent corporation from making periodic distributions of small amounts of stock and securities in a subsidiary as a substitute for ordinary dividends." Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders,* (2d ed.), p. 479; see, also, Surrey & Warren, *op. cit. supra,* at p. 1640. Here, as the Ninth Circuit recognized, "it was impossible to determine whether the final distribution would take place in two, three or even ten

years, depending upon Pacific's need for additional capital" (R. 331). Nothing in the Second Circuit's analysis would have prohibited Pacific from distributing one-tenth of the Northwest stock in each of ten successive years, so long as Pacific had a general plan and evidenced a legitimate business purpose. Yet, that sort of distribution would undoubtedly have been viewed as a dividend, both by Pacific and its shareholders (see R. 130, 135). Or, Pacific, having the same business purpose as it did in this transaction, could have distributed rights to the Northwest stock in eight equal installments, beginning in September 1961, when the first offering was in fact made, and ending in June 1963, when Pacific did offer the remaining 43 percent of the Northwest stock. Had eight such offerings been made, the value of each offering could have been close to the 30 cents per share quarterly dividend Pacific paid after it sold the first block of Northwest stock.[17]

Nor does it suffice to say, as the Second Circuit did (R. 293), that "an adequate restriction" against such use of the spin-off "is already provided by subsection (a)(1)(B)." By its express terms, Section 355 (a)(1)(B) would foreclose only those transactions "used *principally* as a device for the distribution of

---

[17] The record does not show the value of the rights distributed in 1963. Those distributed in 1961 had a value of approximately $1.86 per share on September 20, the date of distribution. The average value of the rights, while they were available, ranged from $1.56 to $1.98. (R. 140.) Assuming that there was no substantial change in the value of the Northwest stock in the following twenty months, the value of rights to all the stock at the $16 per share price would have been approximately two-thirds higher—for a total in the vicinity of $3.25.

the earnings and profits of the distributing corporation." (Emphasis supplied.) No doubt Pacific, having the same principal purposes as it did in the transaction actually used, could have made eight equal quarterly distributions of rights. Distribution of the earnings and profits would have been a purpose of Pacific, but it is not clear that it would have been a principal purpose. Cf. *Malat* v. *Riddell,* 383 U.S. 569.

In any event, Congress has decided that Section 355(a)(1)(B) is not by itself "an adequate protection"; Congress otherwise would not have added Section 355(a)(1)(D), since Section 355(a)(1)(B) is virtually the same as the 1951 Act that Section 355 replaces. The 80 percent standard of Section 355 (a)(1)(D), together with the 5-year active business rule of Section 355(b)(2)(B), establish a test that Congress used to distinguish those distributions that may, by design or otherwise, have the effect of a dividend. Section 355(a)(1)(B), in the 1954 Code, offers supplemental protection to the revenue by defeating any "transaction * * * used principally as a device for the distribution" of stock of a long-held operating subsidiary is distributed.

Here, again, Pacific chose to cut one of the "square corners" of Section 355. It could, had it wished, have disposed of all of the Northwest stock in 1961. It preferred to hold 43 percent of the stock until some later date, when it expected to have need for the money it could obtain through selling the stock. That was a perfectly appropriate choice for it to make, but it took the transaction out of Section 355, since

a dividend, even though 80 to 100 percent of

it did not meet the requirement that it distribute either all of the stock of the controlled corporation or "an amount of stock in the controlled corporation constituting control within the meaning of section 368(c)," which is 80 percent.

IV. SHAREHOLDERS WHO SOLD AND DID NOT EXERCISE THE RIGHTS PACIFIC DISTRIBUTED THEREBY REALIZED ORDINARY AND NOT CAPITAL INCOME

There remains the question of the proper tax treatment of the rights which were sold by the taxpayers in No. 760.

1. If Pacific's 1961 disposition of Northwest stock fails to qualify for nonrecogition treatment under Section 355, amounts received on the sale of the stock rights constitute dividend income. See *Choate* v. *Commissioner,* 129 F. 2d 684 (C.A. 2); *Gibson* v. *Commissioner,* 133 F. 2d 308 (C.A. 2); see also *Palmer* v. *Commissioner, supra,* 302 U.S. at 69.

2. There has been a widespread notion that the *Palmer* case decided that the receipt of rights to buy portfolio shares [18] did not constitute income. The Second Circuit relied on this idea in concluding that the proceeds of the rights were capital, if the transaction qualified under Section 355. However, in the *Palmer* case, as we have already pointed out (pp. 26–27, *supra*), the purchase price fixed in the rights was identical with the fair market value of the property offered. Thus, the rights in that case had little or no

[18] "Portfolio" shares refer to stock one corporation owns in another.

value at the time they were declared by the corporate board of directors. It is true that the rights had some value at the time they were received, and that the Court concluded that this value should not be taken into account on receipt. However, the Court clearly recognized that the situation would be different if the purchase price fixed in the rights for the shares offered was less than their fair market value at the time the rights were declared. This Court said (302 U.S. at 69):

> On the other hand such a sale, if for substantially less than the value of the property sold, may be as effective a means of distributing profits among stockholders as the formal declaration of a dividend. The necessary consequence of the corporate action may be in susbtance the kind of a distribution to stockholders which it is the purpose of § 115 to tax as present income to stockholders, and such a transaction may appropriately be deemed in effect the declaration of a dividend, taxable to the extent that the value of the distributed property exceeds the stipulated price. * * *

3. In any event, the method of taxing rights was subjected to comprehensive overhaul by Congress in the Internal Revenue Code of 1954. Section 305 of that Code provided that distributions by a corporation of its own shares, or of rights to acquire its own shares, did not constitute income, except in two minor situations not relevant here. At the same time, Congress provided in Section 301(a) of the Code as follows:

> Except as otherwise provided in this chapter,

> a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

"[S]ubsection (c)," together with Section 316, directs that such "a distribution of property" is to be taxed as a dividend to the extent of corporate "accumulated earnings and profits."

The term "property" is defined in Section 317(a) in the following language:

> For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

Thus, it is clear that the word "property" as used in Section 301(a) includes rights to subscribe to portfolio shares. Such rights are obviously "other property." Moreover, it would not have been necessary to exclude "rights to acquire" "stock in the corporation making the distribution" if rights, generally, were not comprehended in the term "property."

Finally, Section 301(b)(1)(A) provides that "the amount of any distribution" shall include "the fair market value" of property received, and Section 301 (b)(3) requires that "fair market value shall be determined as of the date of the distribution."

Thus, it is clear that, under the comprehensive scheme established by Congress in 1954, rights to subscribe to portfolio shares are to be included in income as distributions of corporate property. Moreover, on the basis of the actual language, they are to be in-

cluded as of the date distributed, and at their fair market value on the date they are distributed. The amount so determined constitutes a dividend to the extent of the "earnings and profits" of the corporation.

Thus, under the terms of the statute, the distribution was a dividend, or at least potentially a dividend. Ordinarily, in these cases, there will not be much difference between the value of the rights on the day they are received, and their value on the date they are sold. Analytically, the rights should be considered dividend income on the date distributed. They then become property held by the taxpayer with a basis of the amount of their fair market value on that date, and there is a gain or loss on subsequent sale of the rights measured by the difference between the sale price and the basis. This would be a capital gain or loss, ordinarily short term, since the duration of the validity of rights is generally much less than six months. See Carlson, *Taxation of "Taxable" Stock Rights: The Strange Persistence of Palmer v. Commissioner,* 23 Tax L. Rev. 129.

Although this is the technical analysis of the situation, it is convenient in these cases, where rights are sold, to minimize the amount of computation involved, and to treat the proceeds on sale as being the dividend, rather than the fair market value on the date of the receipt of the rights. In this case, the difference in time between the two events is of no consequence; and the difference in amount is *de minimis.*

4. Even if Section 355 grants nonrecognition to the overall transaction, the proceeds of rights that were sold should be considered ordinary dividend income. The most that can be said, if the transaction did qualify under Section 355, is that Pacific's shareholders received, through the rights to buy the Northwest stock, an option to make one of two decisions. They could pay money to Pacific, and thus continue, through holdings in Northwest, an investment in the telephone business in Oregon, Washington, and Idaho. Or they could sell that option at its market value. Even if the issuance of rights is viewed, in the language of the Second Circuit majority, as a mere "mechanism" for distribution of the Northwest stock, those who sold the rights aborted the mechanical process. Once they sold their rights, they cannot be said in any way to have received stock in Northwest. In this event, they do not qualify for the nonrecognition treatment of Section 355—for Section 355(a)(1) provides that "no gain or loss shall be recognized to (and no amount shall be includable in the income of) such share holder or security holder *on the receipt of such stock or securities.*" (Emphasis supplied.) This obviously refers, in this case, to the Northwest stock; and the taxpayers who sold their rights never received any Northwest stock.

The exceptional treatment of Section 355 is available only to taxpayers who come expressly within its terms, and there is no statutory basis for treating amounts received on the sale of rights as anything other than ordinary income. *Choate* v. *Commissioner*, 129 F. 2d at 689; *Gibson* v. *Commissioner, supra.*

Thus, even if this Court holds that Section 355 allows nonrecognition treatment to those Pacific shareholders who exercised the rights they received to purchase Northwest stock, the Second Circuit should still be reversed to the extent that it held that amounts realized upon the rights that were sold constituted capital gain.

CONCLUSION

The judgment of the Second Circuit should be reversed and the judgment of the Ninth Circuit should be affirmed.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

MITCHELL ROGOVIN,
Assistant Attorney General.

HARRIS WEINSTEIN,
Assistant to the Solicitor General.

GILBERT E. ANDREWS,
MARTIN T. GOLDBLUM,
Attorneys.

FEBRUARY 1968.

APPENDIX

APPENDIX

Internal Revenue Code of 1954, Section 355, 26 U.S.C. 355:

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) *Effect on Distributees.*—

(1) *General rule.*—If—

(A) a corporation (referred to in this section as the "distributing corporation")

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active business) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) *Non pro rata distributions, etc.*—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) *Limitation.*—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) *Cross reference.*—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) *Requirements as to Active Business.*—

(1) *In general.*—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) *Definition.*—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution.

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the times of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

U.S. GOVERNMENT PRINTING OFFICE: 1966